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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1932

No. 448

PETROLEUM EXPLORATION, INC., *Petitioner,*

against

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF PETROLEUM RECLAMATION CORPORATION AS *AMICUS CURIAE*

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INDEX

PAGE

Preliminary Statement 1

Opinions Below 2

Jurisdiction, Question Presented, and Statement of the Case 2

Statutes and Regulations Involved 2

Summary of Argument 3

Argument 4

1. The cost of drilling oil wells is the cost of an "improvement" within the meaning of Section 234 (*a*)(8) and Section 215 (*a*)(2) of the Revenue Act of 1926 4

2. The "allowance for depletion" authorized by Section 204 (*c*)(2) is in lieu of the "allowance for depletion" authorized by Section 234 (*a*)(8) and in addition to the allowance "for depreciation of improvements" authorized by Section 234 (*a*)(8) 5

3. The Revenue Act requires that the cost of drilling oil wells be capitalized and recovered by allowances for depreciation of improvements and the Commissioner of Internal Revenue is without authority by regulation or otherwise to annex as a condition to the capitalization of such cost the requirement that it be recovered by allowances for depletion 7

Conclusion 10

TABLE OF CASES CITED

PAGE

Frederick v. *Klauser*, 32 Oregon 116..... 4

Jergins, A. T., Trust v. *Com.*, 22 B. T. A. 551..... 8

Old Farmers Oil Co. v. *Com.*, 12 B. T. A. 203..... 7

U. S. v. *Ludey*, 274 U. S. 295..... 6

STATUTES CITED

Revenue Act of 1926, Section 204 (*c*)(*2*); [44 Stat. 16] 3, 5, 6

Revenue Act of 1926, Section 215 (*a*)(*2*); [44 Stat. 28] 3, 4, 7, 9, 10

Revenue Act of 1926, Section 234 (*a*)(*7*); [44 Stat. 42] 5, 6

Revenue Act of 1926, Section 234 (*a*)(*8*); [44 Stat. 42] 3, 4, 5, 6, 8, 9

TREASURY DEPARTMENT REGULATIONS CITED

Regulation 69, Article 223.....7, 8, 10

REFERENCE BOOKS CITED

Glossary of Mining and Mineral Industry (Bureau of Mines) 4

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PRELIMINARY STATEMENT

Petroleum Reclamation Corporation and its affiliated corporations have now pending before the United States Board of Tax Appeals petitions for redetermination of deficiencies in income tax alleged to be due by the Com-

missioner of Internal Revenue upon the basis of the same interpretation of the provisions of the Revenue Acts with respect to allowances for depletion and depreciation as is relied upon by the Commissioner in the above-entitled case. Except as to the amounts involved, the facts are similar to those in the instant case. Petroleum Reclamation Corporation is therefore interested in the decision of this Court in the present case and seeks in this brief to set forth the reasons why it is believed that the decision of the United States Circuit Court of Appeals for the Fourth Circuit was in error and that the decision of the United States Board of Tax Appeals was correct.

OPINIONS BELOW

The opinion of the Board of Tax Appeals is reported in 23 B. T. A. 890. The opinion of the Circuit Court of Appeals is reported in 61 Fed. (2d), 273.

JURISDICTION, QUESTION PRESENTED, AND STATEMENT OF THE CASE

We refer to the brief for the Petitioner for statements as to the jurisdiction of this Court, the question presented, and the facts, all of which we adopt.

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations cited in the brief for the petitioner there is also cited herein Section 215 (*a*)(*2*) of the Revenue Act of 1926, as follows:

"Sec. 215(*a*) General rule.—In computing net income no deductions shall in any case be allowed in respect of—* * *.

"(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; * * *."

SUMMARY OF ARGUMENT

1. The cost of drilling oil wells is the cost of an "improvement" within the meaning of Section 234 (*a*)(8) and Section 215 (*a*)(2) of the Revenue Act of 1926.

2. The "allowance for depletion" authorized by Section 204 (*c*)(2) is in lieu of the "allowance for depletion" authorized by Section 234 (*a*)(8) and in addition to the allowance "for depreciation of improvements" authorized by Section 234 (*a*)(8).

3. The Revenue Act requires that the cost of drilling oil wells be capitalized and recovered by allowances for depreciation of improvements and the Commissioner of Internal Revenue is without authority by regulation or otherwise to annex as a condition to the capitalization of such cost the requirement that it be recovered by allowances for depletion.

ARGUMENT

1. The cost of drilling oil wells is the cost of an "improvement" within the meaning of Section 234 (*a*)(8) and Section 215 (*a*)(2) of the Revenue Act of 1926.

The Revenue Act contains no definition of "improvement". That the drilling of an oil well constitutes an improvement to the property in the ordinary and accepted sense of that term in common usage requires no argument. Here it is used in connection with natural resources. Its meaning in that connection has been the subject of judicial interpretation. The United States Bureau of Mines in its "Glossary of Mining and Mineral Industry" defines "improvement" in the language of the courts as follows:

> "*Improvement.* As used in the mining statutes, is an artificial change of the physical condition of the earth upon or reasonably near a mining claim as to evidence a design to discover mineral therein, or to facilitate its extraction. It must be reasonably permanent in character (*Frederick* v. *Klauser*, 32 Oregon 116)" (p. 357).

The Revenue Act does not purport to use the term in any special or limited sense. Clearly, therefore, the cost of drilling oil wells must for the purposes of Section 215 (*a*)(2) and Section 234 (*a*)(8) of the Revenue Act of 1926 be considered the cost of improvement to the property and treated accordingly.

2. The "allowance for depletion" authorized by Section 204 (c)(2) is in lieu of the "allowance for depletion" authorized by Section 234 (a)(8) and in addition to the allowance "for depreciation of improvements" authorized by Section 234 (a)(8).

Section 234 of the Revenue Act provides that deductions *shall* be allowed (1) "for depletion" (Section 234 (a)(8)) and (2) "for depreciation of improvements" (Section 234 (a)(8)) as well as (3) "for exhaustion, wear and tear of property used in the trade or business" (Section 234 (a)(7)). The alternative allowance provided by Section 204 (c)(2) is, on the contrary, deliberately confined to an allowance "for depletion". The word "depletion" appears three times in that subdivision. The "allowance for depletion" thereby granted is clearly to be substituted for the "allowance for depletion" made by the provisions of Section 234 (a)(8) and is not to be substituted for the allowance made by that subdivision "for depreciation of improvements".

If Congress had intended that the special allowance for depletion at the rate of 27½% of the gross income should be in lieu not only of the allowance for depletion made by Section 234 (a)(8) but also in lieu of the allowance made for depreciation of improvements by that section, it could have so provided in the simplest terms, and it is to be assumed that it would have done so.

The fact is that the coupling of the allowances for depletion and for depreciation of improvements in the same subdivision points clearly to the distinction between the allowances which it is intended to grant. It is too

clear to require argument that "depletion" does not include "depreciation of improvements". The distinction between the two terms is, moreover, clearly set forth in the opinion of this Court in *U. S.* v. *Ludey,* 274 U. S. 295, at pp. 300 and 302. "Depletion" relates peculiarly to natural resources, that is to the ore, the oil or the timber in its natural state. Any expenditures which may be incurred in developing such natural resources and which do not constitute an expense of operation to be deducted currently, constitute an improvement. Under this head naturally falls the cost of drilling wells.

It follows that the allowance for depletion made by Section 234 (*a*)(8) and Section 204 (*c*)(2) can not include any allowance for recovery of such costs. There is ample provision for the allowance of such recovery in the provisions of Section 234 (*a*)(8) as to depreciation of improvements and in the provisions of Section 234 (*a*)(7) as to exhaustion of property used in the trade or business.

Since drilling costs constitute improvements the treatment for which the respondent contends is tantamount to substituting the allowance for depletion under Section 204 (*c*) (2) for the allowance for depreciation of improvements as well as the allowance for depletion under Section 234 (*a*) (8). Except for the fact that the allowance for depletion and the allowance for depreciation of improvements are incorporated in the same subdivision of the Act it would be equally reasonable for the respondent to maintain that the allowance granted by Section 204 (*c*) (2) is to be substituted for the allowance for exhaustion, wear and tear granted by Section 234 (*a*) (7).

3. The Revenue Act requires that the cost of drilling oil wells be capitalized and recovered by allowances for depreciation of improvements and the Commissioner of Internal Revenue is without authority by regulation or otherwise to annex as a condition to the capitalization of such cost the requirement that it be recovered by allowances for depletion.

The cost of drilling oil wells is undoubtedly an expenditure incurred for the improvement and betterment of the property. Section 215 (*a*)(*2*) forbids the deduction of such expenditures currently and the Board of Tax Appeals has held in *Old Farmers Oil Company* v. *Commissioner* 12 B. T. A. 203 that the Revenue Act did not confer any authority upon the Commissioner to determine arbitrarily by regulation that a purely capital item was a business expense. It follows that the option which the Commissioner undertakes to grant in Article 223 of Regulations 69 is an option or privilege to deduct such items as an expense contrary to the provisions of Section 215 rather than an option or privilege to capitalize such items. Capitalization is the normal course; deduction as expense the exception. Since the favor extended appertains to the deduction as expense, the Commissioner might properly annex a condition to the exercise of the option to deduct expenditures currently but he may not in any event annex to the treatment of such items as capital expenditures (which is what the law requires) any condition such as the requirement that the recovery of the expenditure be had through depletion allowances. The regulation is not, therefore, in this aspect a proper exercise of the authority granted to the Commissioner

by Section 234 (*a*)(8) to prescribe rules and regulations for the determination of the allowance to be made pursuant to that subdivision. In this respect the United States Board of Tax Appeals in *A. T. Jergins Trust* v. *Com.*, 22 B. T. A. 551 said:

> "If this regulation is susceptible of the construction which has been placed upon it in this case, it is in conflict with the provisions of the statute, which allows improvements to be depreciated."

From the foregoing, it will be evident that the Circuit Court of Appeals for the Fourth Circuit erred in its decision in this case through misapprehension of the nature of the option which the Commissioner offers to taxpayers by the provisions of Article 223. In its decision the Court suggests that there was an "implied agreement to accept depletion when the taxpayer exercised the option to charge the expense to capital account" (p. 276) and holds that

> "* * * the regulations are reasonable, and, having been in force for a long time, they should be sustained, particularly where the taxpayer, as in this case, availed itself of the identical regulations to capitalize expenditures for intangibles, thus accepting the provision that such expenditures should be returned through allowances for depletion. The taxpayer cannot accept the benefits of the regulation and reject the accompanying obligation" (p. 277).

The Court failed to recognize that the capitalization of the expenditures in question was required by Section

215 (*a*)(2) and that their capitalization in the instant case was in conformity with the statute. The petitioner did not avail itself of a privilege granted by the Commissioner in exercising its right to comply with the requirements of Section 215 (*a*)(2) but refrained from availing itself of the privilege to deduct the expenditures currently. This being so, no agreement can be implied to accept depletion as the basis for recovery of the expenditures. The benefit which the regulation extends is the privilege to deduct expenditures currently. Any other interpretation of the regulation would impair its validity. This would be true irrespective of the practice to which the Commissioner may have adhered under the regulation, since the position that the option extended is an option to capitalize is untenable in the light of the provisions of Section 215 (*a*)(2). In order to support such a position it would be necessary for the respondent to argue that the Commissioner might by regulation change the statute. The true question would seem to be whether the Commissioner has the authority under Section 234 (*a*) (8) to extend the option to deduct such expenditures currently.

On page 38 of the brief for the Respondent in *The United States* v. *Dakota-Montana Oil Company*, now pending before this Court, (No. 434), it is demonstrated that the inevitable effect of restoring capitalized drilling cost through depletion is to impose upon the taxpayer who capitalizes drilling cost a greater tax than is imposed upon the taxpayer who charges off such cost as an expense. In other words, if, as we contend, the provisions of Section 215 (*a*)(2) require the capitalization of drilling cost and such cost may be deducted currently

only by reason of the extraordinary favor granted by the Commissioner as an option under Article 223, the effect of coupling with the option the requirement that capitalized drilling cost be recovered through depletion is unlawfully to discriminate between the taxpayer who avails himself of the privilege to deduct cost currently and the taxpayer who complies with the statute and capitalizes such cost. The authority to charge as an expense is derived from the regulation only. The authority to capitalize is derived from the statute and does not necessarily rest upon any regulation. May the taxpayer who follows the statutory requirement be taxed more than he who looks solely to the regulation for support? Surely, the Commissioner has no power thus to discriminate between taxpayers and by regulation to alter the amount of tax otherwise collectible.

CONCLUSION

It is submitted, therefore, that the decision of the United States Board of Tax Appeals was correct and that the Court below erred in reversing the Board. In order to sustain the decision of the Court below, it would be necessary to disregard the only reasonable interpretation of the word "improvement"; and to hold that the Commissioner might by regulation dispense with the provisions of Section 215 (*a*)(2) of the Act and annex to the exercise by a taxpayer of his right to comply with the requirements of that Section a condition which does violence to the terms "depletion" and "depreciation" as

defined by this Court. The decision of the Court below should be reversed.

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